Office of Chief Counsel Internal Revenue Service

memorandum

CC:LM:HMT: :1:POSTF-145302-02

date: November 18, 2002

to: , International Team Manager Attn: , International Examiner

from: Associate Area Counsel, (LMSB)

subject: Inc.

Tax Year Ended:

Worthless Stock Loss:
Bad Debt Deduction:

This memorandum responds to your recent request for assistance. This memorandum should not be cited as precedent.

You requested our endorsement of the position you intend to take in disallowing two separate deductions claimed by

Inc. ('s) from foreign operations.

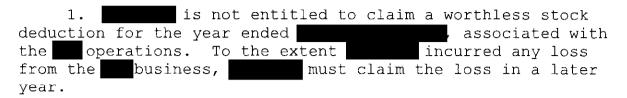
Based upon our review of the administrative files, we concur with your proposed disallowance of the two deductions.

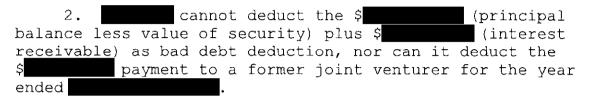
<u>Issues</u>

1.	Ιs		pe	ermitt	ed t	0	claim	. a \$			deducti	ion
pursuant	to	Sectio	n 16	65 (g) ((3) f	or	the	year	ende	d		
, as:	soci	ated w	ith	stock	in							
subsidia	ries	that	oper	rated			res	taur	ants (during	5	

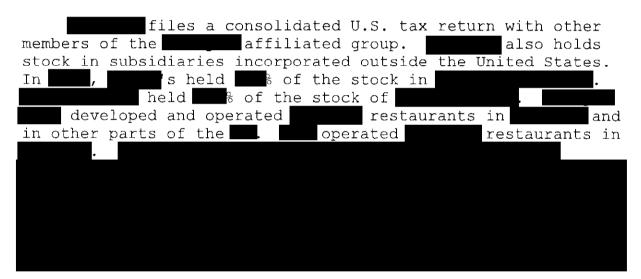
2. Is permitted to claim a total of \$ in deductions for the year ended under the circumstances described below associated with a subsidiary that operated restaurants in ?

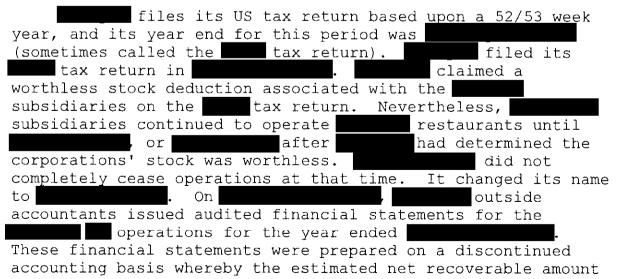
Conclusions





Background -- Subsidiaries





of the assets was used in the financial statements instead of historical cost. During and and sold off some of the assets of the restaurants and shipped the remaining unsold assets to

did not commission any formal study of the fair market value of the the stock or assets of for FAS or FAS 121 purposes, for US tax purposes. The tax loss was computed based upon the amount of outstanding intercompany obligations. Over the years, the corporations borrowed from the US parent to fund ongoing losses. capitalized the obligations, added them to the basis in the stock, and claimed a loss for that amount.

On or about _______, a director of ______ signed two Forms 8832, "Entity Classification Election", to change the classification of ______ from a corporation to a disregarded entity for US tax purposes. The election for was retroactive to ______ and the election for ______ was retroactive to ______ Two days later, _____ liquidated into its parent ______ Two days later, ______ liquidated. The consequences of these entity classification changes are reflected on ______ tax return.

The change in entity classification, itself, is a deemed liquidation of the corporations. Sections 7701 and 367 as well as the related Sections discussed below describe the tax consequences of a liquidation of a foreign corporation. We do not know the extent to which seeks to use the accumulated losses of these foreign operations to offset US income or to affect any foreign tax credit computations.

We note that Section 332 can apply to this arrangement. If the subsidiaries are not completely worthless when liquidated, Section 332 would prohibit any loss deduction. Section 381 would allow the parent to succeed to the tax attributes of the subsidiaries. You might then want to examine whether the subsidiaries have capitalized any R&E expenses or start-up and carrying charges. Those items would be amortizable later.

You have not requested that we opine on the US parent's ability to use any deficit in E&P or any positive foreign tax

pools. (See Sections 381 and 902) You also have made no issue of the foreign or domestic source of any potential loss. You have not challenged the amounts the taxpayer uses in the Section 165(g)(3) computation. Consequently, this memorandum will not address any of those issues.

In discussions with this office, you made clear that you are developing a timing issue, only. You are challenging right to claim the loss on the return. You do not deny that is entitled to some deduction from the discontinued operations, at some later time. Nevertheless, your position is that is not entitled to any loss deduction in under Section 165(g)(3) for the operations.

Analysis

For the reasons described below, we endorse your disallowance of the loss claimed by . Section 165(a) allows as a deduction any loss sustained during the year not compensated by insurance or otherwise. Under Section 165(g)(1), if any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall be treated as the sale or exchange, on the last day of the taxable year, of a capital asset.

Section 165(g)(3) provides an exception to the general rule of Section 165(g)(1) by allowing ordinary loss treatment for worthless stock held in certain affiliated corporations, even if the stock is a capital asset. To qualify, the taxpayer must meet the requirements found in Section 165(g)(3). We assume the ownership percentage and gross receipts percentage tests have been met.

Section 165(g)(3) has produced substantial controversy and litigation, and a frequently cited opinion interpreting Section 165(g)(3) is <u>Morton v. Commissioner</u>, 38 B.T.A. 1270, 1278-79 (1938), nonacq. 1939-1 C.B. 57, aff'd, 112 F.2d 320 (7th Cir. 1940).

A loss by reason of the worthlessness of stock must be deducted in the year in which the stock becomes worthless and the loss sustained, that the stock may not be considered worthless even when having no liquidating value if there is a reasonable hope and expectation that it will become valuable at

some future time, and that such hope and expectation may be foreclosed by the happening of certain events such as the bankruptcy, cessation from doing business, or liquidation of corporation, or the appointment of a receiver for it. Such events are called "identifiable" in that they are likely to be immediately known by everyone having an interest by way of stockholdings or otherwise in the affairs of the corporation; but, regardless of the adjective used to describe them, they are important for tax purposes because they limit or destroy the potential value of stock.

The ultimate value of stock, and conversely its worthlessness, will depend not only on its current liquidating value, but also on what value it may acquire in the future through the foreseeable operations of the corporation. Both factors of value must be wiped out before we can definitely fix the loss... If [the corporation's] assets are less than its liabilities but there is a reasonable hope and expectation that the assets will exceed the liabilities of the corporation in the future, its stock, while having no liquidating value, has a potential value and cannot be said to be worthless. The loss of potential value, if it exists, can be established ordinarily with satisfaction only by some "identifiable event" in the corporation's life which puts an end to such hope and expectation.

Morton established a two-part test for the finding of worthlessness of stock. First, the subsidiary must be insolvent with no liquidating value, i.e., the corporation has an excess of liabilities over assets. Second, the subsidiary must lack potential value. Austin Co. v. Commissioner, 71 T.C. 955, 969-70 (1979), acq. 1979-2 C.B. 1. The stock must be worthless under both factors before the loss is fixed. See Figgie International v. Commissioner, 807 F.2d 59, 62 (6th Cir. 1986).

Regulations promulgated under Section 165 contain many of the requirements quoted above in $\underline{\text{Morton}}$. Specifically, Treas. Reg. § 1.165-1(b) requires that to be allowable as a deduction under Section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events. See

also, Boehm v. Commissioner, 326 U.S. 287, 292 (1945) (upholding validity of regulation). The taxpayer must suffer an economic loss during the year. Commissioner v. Fink, 483 U.S. 89, 97-98 (1987). No loss is allowed unless the stock is wholly worthless. Treas. Reg. § 1.165-5(c) and (f). A mere shrinkage in the value of stock, even though extensive, does not give rise to a deduction under Section 165(a), if the stock has any recognizable value on the date claimed as the date of loss. The burden of showing worthlessness is on the taxpayer. Boehm, 326 U.S. at 294.

We believe your best argument is challenging worthless stock deduction is that the subsidiaries continued to operate their respective businesses throughout and operated restaurants until which is after the date claims the stock became worthless. Claim of worthlessness is premature.

Under Morton, there are two ways of showing lack of potential value, either liabilities so exceed the assets that there is no hope for recovery or by identifiable events demonstrating the worthlessness of the stock. has not shown that the subsidiaries are so insolvent that there is no hope of recovery. To be sure, the book value of the assets exceeded the book value of the stated liabilities of the subsidiaries on that date. However, a closer look at the liabilities might reveal that has characterized some equity as debt. We do not know if "loans" to these subsidiaries were evidenced with a note. Nevertheless, if we successfully recast some portions of the stated debt as equity, may no longer be insolvent based upon its balance sheet.

We note that capitalized all its outstanding liabilities owed by and by These amounts were rolled into the stock basis computation. We do not know when these debts were due. Some of the debts may stretch into later years. Some of the debts were owed to third parties. Those third party debts would not be paid until due, perhaps years later.

almost certainly has assets, primarily intangibles, not included in the asset section of the balance sheet. going concern value must be considered in determining the value of the subsidiaries assets as of

the approximate date of liquidation. See Sika Chemical Co. v. Commissioner, 64 T.C. 856, 863 (1975), aff'd without opinion, 538 F.2d 320 (3d Cir. 1976); Hawkins v. Commissioner, T.C. Memo. 1987-91. There may also be some value attached to other intangible assets. See Wally Findlay Galleries International, Inc. v. Commissioner, T.C. Memo. 1996-293.

The second part of the Morton test involves a reasonableness test, would a reasonable businessperson consider that the stock has potential value? Had commissioned a fair market value study as of we might more seriously consider naked claim that the corporation had no potential value. However, continued operation of the businesses combined with unexplained action of changing the name of undercuts necessary contention that the businesses had no potential value. In fact, a fair question to raise at this time is whether and insolvent and without potential value as of the following , or even the year after that. Would a prudent businessman have considered the stock of the subsidiaries worthless on ? Probably not, and neither do we. The combination of increasing and recasting some debts as equity might convert a solvent corporation.

Section 385 and case law provide some guidance in determining whether any amounts forwarded by to the subsidiaries is debt or equity. During the next cycle, you may want to closely examine the subsidiaries intercompany obligations owed to

response to your challenge will include a mention of the fact that the entities were deemed to have liquidated when filed the entity classification change.

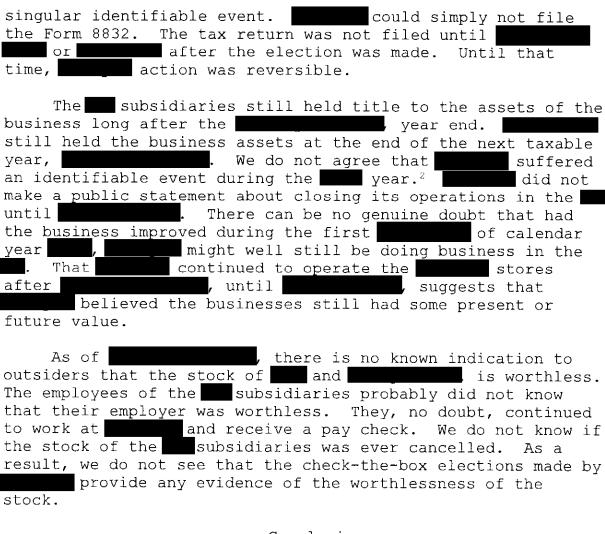
¹Section 385(b) lists the following factors that the regulations may include in making such a determination: (i) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest, (ii) whether there is subordination to or preference over any indebtedness of the corporation, (iii) the ratio of debt to equity of the corporation, (iv) whether there is convertibility into the stock of the corporation, and (v) the relationship between holdings of stock in the corporation and holdings of the interest in question. Because you intend to disallow the taxpayer's claimed loss for reasons other than those contained in Section 385, we will postpone any further discussion of these provisions.

will claim that this is the identifiable event required by Treas. Reg. § 1.165-1 and by the Morton case. By virtue of this deemed liquidation, the assets are deemed to be distributed to the shareholder and, immediately thereafter, used as assets of a branch. Treas. Reg. § 301.7701-3(g)(1)(iii). anticipated response will be meritless. This deemed liquidation was ruled out as an identifiable event a long time ago. In fact, the Morton decision, supra, dismissed that argument.

The liquidation of the subsidiaries was a liquidation in form only. In substance, the "liquidated" corporation continued to operate just as it had before the liquidation. The liquidation was accomplished by filing a form with the US tax return which itself was filed in . The stock of the insolvent subsidiaries is not worthless simply because the taxpayer makes a check-the-box election and is retroactively "liquidated" for US tax purposes 2 - 3 months earlier.

The recognition event for a worthless stock loss occurs, not when any single identifiable event occurs, but when there is no further ability to recover the taxpayer's investment. Identifiable events act to secure that point in time. In <u>Ditmar v. Commissioner</u>, 23 T.C. 789, 798 (1955), the Service argued that the stock of an unsuccessful company became worthless in the year the company sold its assets and went out of business, both of which are identifiable events listed in Morton. However, the Tax Court agreed with the taxpayer that the stock did not become worthless until the next year when the taxpayer received his last distribution upon liquidation. The court found that this was the identifiable event fixing worthlessness because at that point "there was no prospect that he would receive any more." Reese Blizzard v. Commissioner, 16 BTA 242 (1929), no recognition event until the final disposition of property by trustees.

Identifiable events must be analyzed in the context in which they occur to determine if they either evidence or cause the utter worthlessness of the stock. Signing and filing a Form 8832 cannot be the identifiable event required by the authorities cited and quoted above. Those authorities used as examples actions like bankruptcy, cessation of business, or liquidation. Frequently, all three events occur at or about the same time. It was possible for to undo this



Conclusion

For these reasons, we conclude that has not established that the stock of the subsidiaries was worthless as of the seeks to claim the loss. For this reason, we endorse your challenge of claimed loss.

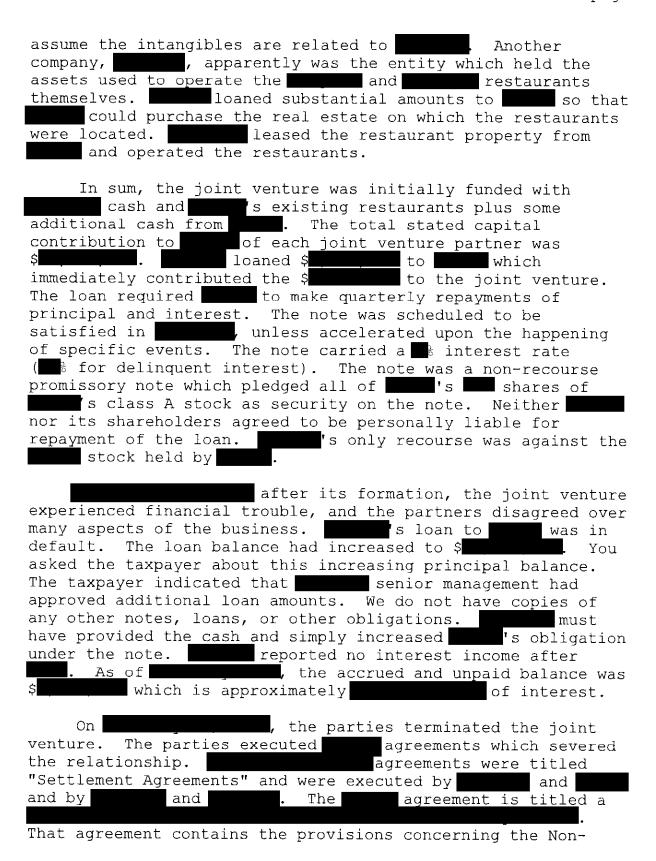
²If an entity is solvent at the time of its liquidation, the parent corporation is not entitled to worthless stock deduction under Section 165(g). Furthermore, a transfer of the subsidiary's assets and liabilities to the parent under section 301.7701-3(g)(1)(iii) generally should qualify as a Section 332 liquidation of subsidiary into a parent if the subsidiary is determined to be solvent at the time of its liquidation. See <u>Treas. Req.</u> § 1.367(b)-3 and Rev. Rul. 72-421, 1972-2 C.B. 166, for some of the possible consequences of such liquidation.

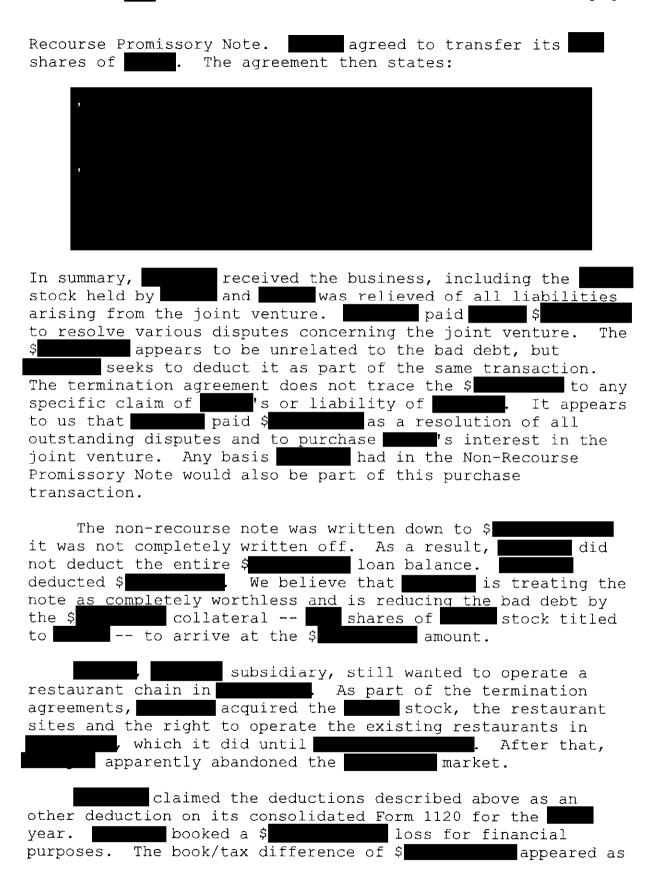
Background -- Joint Venture

On the same tax return that claimed the worthless stock deduction, claimed a total of \$ of deductions related to a joint venture which developed and operated restaurants in . The \$ is composed of three separate items: a write off of a note receivable from the joint venture partner named in the amount of \$; the interest due on the note in the amount of \$; and a settlement payment to upon termination of the joint venture in the amount of \$. For the reasons described below, we support your challenge of these three items.

"Other Deductions" on the tax return for the year ended has not yet provided an explanation detailing its position with respect to this issue. We anticipate that this issue will evolve after articulates its legal position. For that reason, our endorsement of your position is provisional, and it should be reviewed if you receive more information.

became one joint venture partner along with corporation. Together and formed Corporation, also a corporation, and corporation. The common stock of was divided equally between and shares of snonvoting preferred stock. The common stock of was divided equally between shares each. Was a holding company the income from which is included in sincome pursuant to Subpart F. sincome consisted primarily of interest; sassets were notes receivable. The held the real estate or the leases for the real estate for the restaurants along with the intangibles for the business. We





a Schedule M-1 adjustment as an expense which reduced book income but not taxable income. You have challenged the deduction on essentially the same grounds that you challenge the deduction for the subsidiaries.

In response to your inquiry, has cited Section 166, "Bad Debts", as the Code Section which allows these deductions. contends, in summary, that the nonrecourse note was worth approximately \$ since received the shares of stock when it foreclosed upon/forgave the debt owed by The difference, \$ plus the \$ accrued interest, is what seeks to deduct as a bad debt. has not made a different argument or justification for deducting the \$ payment to in settlement of other disputes arising from the failed joint venture.

Analysis

We concur with your disallowance of the taxpayer's claimed deduction at this time. did not have a bad debt, it had a bad joint venture. The amounts lost in the joint venture are probably not deductible until it disposes of the stock, and that occurred after

Section 166 governs deductions for bad debts, other than a debt evidenced by a corporate or Government security.³ Section 166(a)(1) provides that a deduction shall be allowed for any debt that becomes worthless within the taxable year. Corporate bad debts give rise to a deduction against ordinary income upon their complete or partial worthlessness. A deductible bona fide debt arises from a debtor-creditor relationship based on a valid and enforceable obligation to pay a fixed or determinable sum of money. Treas. Reg. \$ 1.166-1. There must be a reasonable expectation and intent that repayment will be made. If a shareholder's advance to his corporation is a capital contribution, it becomes part of his investment in the stock. Generally, a capital contribution is an investment placed at the risk of the business. In contrast, a debt is intended to create an

 $^{^3}$ For purposes of Section 166, a security means a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form. Sections 166(e) and 165(g)(2)(C).

obligation which is payable irrespective of the success of the business.

Is this a debt? If so, was it worthless? Whether a payment is equity or a debt is a question of fact to be decided on a case by case basis. See <u>Gilbert v. Commissioner</u>, 262 F.2d 512, 513 (2d Cir. 1959), aff'g. T.C. Memo. 1958-8. Courts have traditionally utilized a number of factors in determining whether an instrument is debt or equity:

- 1) The names given to the certificates evidencing the debt or equity;
 - 2) The presence or absence of a maturity date;
 - 3) The source of the payments;
- 4) The right to enforce payment of principal and interest;
 - 5) Participation and management;
- 6) A status equal to or inferior to that of regular corporate creditors;
 - 7) The intent of the parties;
 - 8) "Thin" or adequate capitalization;
- 9) Identity of interest between creditor and stockholder;
- 10) Payment of interest only out of "dividend" money; and
- 11) Ability to obtain loans from outside lending institutions.

Bauer v. Commissioner, 748 F.2d 1365, 1368 (9th Cir. 1984). No one factor is controlling or decisive, and the court must look to the particular circumstances of each case. "The object of the inquiry is not to count factors, but to evaluate them" Tyler v. Tomlinson, 414 F.2d 844, 848 (5th Cir. 1969). Another recent case is Flint Industries v. Commissioner, T.C. Memo. 2001-276, 2001 TNT 197-9.

We are not going to analyze each of the eleven factors in this memorandum. We will note that called the \$ a debt, and agreed to that description.

Nevertheless, the terms of the debt make it difficult, or impossible, for the debtor to enforce payment absent the success of the joint venture. That makes it look more like equity.

The transactions which occurred at the termination of the joint venture, make the alleged bad debt situation so look more like a purchase of stock. The unpaid nonrecourse loan was never going to be paid by the paid off from profits from the joint venture. If the joint venture succeeded, the note would be repaid; if it failed, then the note would fail, and but not would lose financially. You could make a credible argument that the loan was equity, not debt.

Ultimately, we recommend you take additional action after you determine more about position on this matter. We believe the \$ payment made by to should not be treated as part of any alleged bad debt. The items which really are bad debts appear to have been deducted prematurely. We have substantial questions about the valuation of the security for the debt, shares of 's common stock. For these reasons, we endorse your challenge of the bad debt deduction and the deduction of the payment.

Conclusion

We endorse your disallowance of the three items which
constitute \$ bad debt deduction for the year
ended . We recognize that could
provide some additional information in support of their case
or articulate a theory which might allow for the deduction of
some or all of this amount. For that reason, our endorsement
is provisional, only. Nevertheless, we would be receptive to
further consultation on this issue should provide
additional information. Should you have questions about this
memorandum, please contact

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views

Associate Area Counsel (LMSB)

By:
Senior Attorney (LMSB)